Office of Chief Counsel
Internal Revenue Service

memorandum

CC:FIP:4:POSTS-126543-04

date:

to: Robert C. Harper
Manager, EO Technical Group 3
T:EO:RA:T:S

from: Mark Smith
Branch Chief
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subject: **Request for Technical Advice**
[redacted]
Years Involved: [redacted]

This responds to your May 13, 2004, Technical Assistance Request in connection with the above-referenced Request for Technical Advice.

ISSUE

Whether [redacted] qualified as an insurance company for federal income tax purposes for [redacted] ("Years Involved").

CONCLUSION

For the reasons explained below, we conclude that [redacted] did not qualify as an insurance company for federal income tax purposes for the Years Involved.

FACTS

The facts presented in the Request for Technical Advice reflect the following.

1. [redacted] is a wholly owned subsidiary of [redacted] [redacted] is a federally regulated bank with operations in [redacted]. [redacted] provides private and business banking services to small and middle market companies and high net worth individuals. [redacted] offers commercial and personal loans, deposit, cash management, and international banking services, and mutual fund

investments. [redacted] finances automobile, credit card, small business, mortgage, and line of credit loans.

2. In addition to its banking activities, [redacted] earned income from other sources, including a 90% interest in a trust known as the [redacted]. Partnership's primary assets were [redacted] which the Partnership leased to [redacted] On its books, Partnership carried the [redacted] at salvage, all allowable depreciation having accrued[1]. The Partnership valued the lease at $4,714,567, and it generated approximately $1.5 million of annual revenue for the Partnership. Partnership was managed by a trustee.

3. [redacted] activities placed [redacted] in a position to offer several lines of insurance products to its customers. These included protection against a borrower's disability or financial hardship and fraud upon a depositor.

4. In [redacted] 1998, [redacted] developed a business plan for entering the reinsurance market. The ostensible purpose of this plan was to allow [redacted] to profit from these lines, both as underwriter [redacted] and as commission sales agent [redacted] The plan involved establishing a company [redacted] in the [redacted] to reinsure these risks, and, in the future, to reinsure various risks of [redacted] In order to comply with federal banking law, [redacted] would create a wholly owned subsidiary, [redacted], which in turn would be the sole owner of [redacted] Though [redacted] intended to utilize sound underwriting protocols and implement an effective claims control program, because [redacted] would engage in reinsurance of coverage sold to [redacted] customers (and, in the future, of coverage provided [redacted], it was not anticipated that [redacted] would engage in marketing activities nor would it have any employees; administrative tasks were to be outsourced. There is no discussion of [redacted] utilizing office space.

5. The business plan envisioned [redacted] being capitalized with approximately $5 million - $500,000 in cash/marketable securities, and $4.5 million "in an asset which generates significant annual cash flow", i.e., [redacted] interest in the Partnership.

6. [redacted] was incorporated under the General Corporation Law of [redacted] as a wholly owned subsidiary of [redacted] and was organized under that state's Insurance Code.

7. To comply with federal banking law, on [redacted], [redacted] and the Board of Governors of the Federal Reserve System entered into an agreement allowing [redacted] to hold all of the issued stock of [redacted]. It was understood that [redacted] was to serve as an "agreement corporation" for purposes of the Federal Reserve Act to hold the shares of [redacted], and that [redacted] activities were to be limited to reinsuring credit risks and the risks of loss due to check fraud.

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1 The partnership agreement provided that the depreciation was allocable to [redacted]

8. When it applied to the Federal Reserve for this agreement, [redacted] represented that in addition to the par value capital, [redacted] "will receive an asset of [redacted] with a fair market value of approximately $4.5 million. The purpose of transferring this asset is to provide [redacted] with adequate capital for both current and future business." The application also states that [redacted] and [redacted] had been engaged as consulting actuary and public auditor, respectively.

9. [redacted] was established on [redacted] under [redacted] Memorandum of Association indicates that its objects and powers include "the business of insurance, captive insurance, and reinsurance, to act as agents and/or brokers for insurance companies and syndicates, to accept risks, settle claims, [illegible] insurance business and all other matters incidental thereto." [redacted] was authorized to issue [redacted] shares with a par value of $1.00 for total initial capitalization of $ [redacted] was capitalized as described in Facts 5 and 8[2].

10. [redacted] elected under § 953(d) of the Internal Revenue Code to be treated as a domestic corporation.

11. [redacted] entered into an Agency Agreement dated December 1, 1998, with [redacted] an unrelated company. The agreement appointed [redacted] an agent of [redacted] to solicit applications for credit life and credit disability insurance from [redacted] mortgage debtors under the terms of coverage set out by [redacted]

12. On February 2, 1999, [redacted] applied to [redacted] for group credit policy covering [redacted] debtors effective December 1, 1998.

13. At some point, [redacted] ceded to [redacted] the credit life and disability risks [redacted] assumed under the policies [redacted] sold as its agent. [redacted] is unrelated to [redacted]

14. On [redacted] 1998, [redacted] retroceded the credit life and disability risks to [redacted]. This agreement was augmented by a [redacted] whereby a trust account was opened for the sole use and benefit of [redacted] This account was to contain investments in obligations of the United States, certificates of deposit, or high-grade corporate debt instruments, in an amount equal to 100% of the reserves in accordance with the retrocession agreement.

15. On [redacted] 1998 [redacted] solicited seven officer/employees of [redacted] who were also mortgagors to purchase credit disability coverage offered by [redacted]. Of the seven, five accepted. [redacted] issued credit disability policies to the five officer/employees at the end of [redacted] 1998 effective for one

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2 We offer no opinion on the tax consequences of, or the tax attributes arising from, this capitalization.

year, for an aggregate direct premium of $2,054.84. These policies provided that in the event the policyholder became totally disabled for more than 30 days (subject to exclusions), [redacted] would pay a stated amount per month until "elimination" (e.g., the policy expires or the loan is satisfied). The benefit amount was determined by reference to the policyholder's monthly loan payment: the benefit amount was set at the greater of the loan payment or $1,000. It is unknown whether any of these officer/employee policyholder filed a claim for benefits or [redacted] experience with respect to similar policies.

16. These internal memoranda were the extent of [redacted] solicitation efforts as agent for [redacted]. The risks covered provided by these policies were, pursuant to the operative reinsurance and retrocession agreements, ultimately assumed by [redacted]. This block of five policies comprise the extent of [redacted] assumed risk during 1998. [redacted] premium was the aggregate direct premium of $2,054.84, less [redacted] agent commission, the reinsurance and retrocession commissions, and any administrative fees.

17. On [redacted] filed an Application for Recognition of Exemption Under Section 501(a), Form 1024, asking to be recognized as an organization described in § 501(c)(15). On this Application, [redacted] indicated that it would possess a "lease receivable", i.e., [redacted] interest in the Partnership, worth $4,714,567. Despite the anticipation that the lease would "generate[] significant annual cash flow", the revenue from this asset was not included in the income projections provided on the Application. At the time of this Application, the retrocession agreement from [redacted] was still [redacted] only insurance activity.

18. On [redacted] the Service issued [redacted] a letter recognizing that as of [redacted] was an organization described by § 501(c)(15) hence exempt from tax under § 501(a).

19. At some point during 1999, two of the officer/employee policyholders cancelled their policies. Of the remaining three policies in force at their expiration, only one renewed.

20. On [redacted] solicited five customers to obtain credit disability coverage offered by [redacted] free of premium. None accepted. This was the extent of [redacted] solicitation efforts as agent for [redacted] during [redacted]

21. As of the end of 1999, the [redacted] policy sold by [redacted] as agent that was still in force was the renewed policy issued to [redacted]. ([redacted] assumed risk during 1999 initially consisted of the five policies issued to the [redacted] officer/employees, of which two were canceled and two were allowed to lapse.)

22. During 2000, [redacted] did not solicit the sale of additional credit risk policies as agent for [redacted] nor were additional [redacted] credit policies

23. [redacted] issued to [redacted] "and depositors of record for Checking, NOW, and Money Market accounts" a policy covering "loss due to forged, stolen or counterfeit checks" of [redacted] depositors, "provided such loss [is] due to forged, stolen or counterfeit checks" drawn on [redacted] accounts during the policy period of October 1, 2000 to October 1, 2001 ("Check Fraud Policy"). The Check Fraud Policy had a deductible of $25,000 per event; that is, [redacted] retained liability for the first $25,000 of loss. The coverage limit of the Check Fraud Policy was $1,200,000. The premium paid by [redacted] upon application for the Check Fraud Policy was $227,204.00. During the covered period, [redacted] suffered a covered loss – over its deductible - of $26,450 which [redacted] paid. However, it appears that of this amount $10,000 was paid during 2000.

24. [redacted] is not related to [redacted]

25. By letter dated [redacted] from [redacted] to [redacted] agreed "to assume 100 percent of the losses from the [Check Fraud Policy]"; "[t]here is no ceding premium."

26. In 2000 [redacted] entered into a management agreement with [redacted] whereby for a fee [redacted] agreed to manage [redacted] operations, including providing necessary personnel, handling correspondence, and maintaining necessary records. However, [redacted] was not authorized to take any action regarding the insurance business, such as resolving claims or making any commitments without the agreement of [redacted]

27. The only known meeting of [redacted] board of directors occurred on October 26, 2000 and lasted four minutes. The minutes reflect that the topics discussed were the results of [redacted] operations through September 30, 2000 and the "status of efforts to sell the [redacted] under lease to [redacted] and owned by [redacted]

28. [redacted] did not have a staff. However, [redacted] an officer of both [redacted] indicates that during some or all of the years involved he spent as much as 20% of his working time on [redacted] matters. [redacted] was not compensated by [redacted] for such work.

29. [redacted] filed Returns of Organization Exempt from Income Tax, Form 990, for the years involved. On its [redacted] Form 990 (covering the period of [redacted]), [redacted] reported program service revenue (i.e., premiums) of $8

3 This may be a misstatement. It appears that the [redacted] were owned by the Partnership. Nothing in the submission reflects a transfer of the railcars to [redacted] However, given that [redacted] partnership interest was 90%, for all practical purposes [redacted] was the owner.

[redacted] reported no expenses incurred.

30. Part IV of the Form 990, the balance sheet, reflected its initial capitalization of $500,000, the contribution of [redacted] interest in the Partnership ("lease receivable") of $4,714,567, and "accounts receivable" which apparently was the total premiums collected with regard to the retrocession of the five credit policies issued to its officer/employees, $1,602. As liabilities, [redacted] reported "loss reserves" of $1,594, which appear to be unearned premiums ($1,594 = "accounts receivable" $1,602 – "program revenue" $8). [redacted] net assets were $5,214,657.

31. On its [redacted] Form 990, [redacted] reported total revenue of $[redacted] comprised of program service revenue of $[redacted] (described in Part VII as "reinsurance premium"), income from securities held of $[redacted] and income from "lease receivable" (i.e., the Partnership) of $[redacted]. Expenses of $[redacted] were reported, comprised of $5,459 for "program services" (described in Part II as "licensing fees") and $10,038 for management and general expenses[5]. The result was net earnings of $1,673,109.

32. On Part IV of its [redacted] Form 990, [redacted] reported "other liabilities" of $[redacted] These liabilities were comprised of a note payable of $15,000 and "unearned premiums" of $314. Loss reserves were reported as $"0". [redacted] reported net assets of $6,818,866.

33. On its [redacted] Form 990, [redacted] reported total revenue of $1,727,427, comprised of $55,577 in "program service revenue" (described in Part VII as "reinsurance premiums"), $62,680 in income from securities held, and $1,609,170 from "lease receivable"[6]. [redacted] reported expenses of $29,016, comprised of $10,000 for "program services" (described in Part II as "claims expense") and $19,016 for management and general expenses (described in Part II as a management fee of $10,000 and a license fee of $9,016).

34. On Part IV of its [redacted] Form 990, [redacted] reported "other liabilities" of $179,945. These liabilities were comprised of accrued professional fees of $3,000, "unearned premiums" of $166,945, and a loss reserve of $10,000. [redacted] net assets were $8,506,712.

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4 The Form 990 is confusing on this. Part IV-A, book-tax reconciliation, reflects that the Partnership produced $1,487,296 of revenue instead of the $1,634,347 reported under Part I.
5 Given that [redacted] indicated that he was not compensated by [redacted] for his work on its behalf, and that the agreement with [redacted] was not reached until [redacted] we are not sure what this expense was for.
6 There is a discrepancy in [redacted] 2000 Form 990 similar to that described at note 8.

LAW and ANALYSIS

a. Law

The business of an insurance company necessarily includes substantial investment activities. Both life and nonlife insurance companies routinely invest their capital and the amounts they receive as premiums. The investment earnings are then used to pay claims, support writing more business or to fund distributions to the company's owners. The presence of investment earnings does not, in itself, suggest that an entity does not qualify as an insurance company.

For the years involved, an insurance company for federal income tax purposes is a company whose primary and predominant business activity during the year was the issuing of insurance or annuity contracts or the reinsuring of risks underwritten by insurance companies. Section 1.801-3(a)(1) of the Income Tax Regulations; § 816(a) (company treated as an insurance company for purposes of definition of a life insurance company only if "more than half of the business" of that company is the issuing of insurance or annuity contracts or the reinsuring of risks underwritten by insurance companies).

Neither the Code nor the regulations define the terms "insurance" or "insurance contract." The United States Supreme Court, however, has explained that for an arrangement to constitute insurance for Federal income tax purposes, both risk shifting and risk distribution must be present. Helvering v. LeGierse, 312 U.S. 531 (1941). The risk shifted and distributed must be an insurance risk. See, e.g., Allied Fidelity Corp. v. Commissioner, 572 F.2d 1190 (7th Cir. 1978), cert. denied, 439 U.S. 835 (1978); Rev. Rul. 89-96, 1989-2 C.B. 114.

Risk shifting occurs if a person facing the possibility of an economic loss resulting from the occurrence of an insurance risk transfers some or all of the financial consequences of the potential loss to the insurer. The effect of such a transfer is that a loss by the insured will not affect the insured because the loss is offset by the insurance payment. Risk distribution incorporates the "law of large numbers" to allow the insurer to reduce the possibility that a single costly claim will exceed the amount available to the insurer for the payment of such a claim. Clougherty Packing Co. v. Commissioner, 811 F.2d 1297, 1300 (9th Cir. 1987). Risk distribution necessarily entails a pooling of premiums, so that a potential insured is not in significant part paying for its own risks. See Humana, Inc. v. Commissioner, 881 F.2d 247, 257 (6th Cir. 1989).

While a taxpayer's name, charter powers, and state regulation help to indicate the activities in which it may properly engage, whether the taxpayer qualifies as an insurance company for tax purposes depends on its actual activities during the year. Inter-American Life Ins. Co. v. Commissioner, 56 T.C. 497, 506-08 (1971), aff'd per curiam, 469 F.2d 697 (9th Cir. 1972) (taxpayer whose predominant source of income was from investments did not qualify as an insurance company); see also Bowers v.

Lawyers Mortgage Co., 285 U.S. 182, 188 (1932). To qualify as an insurance company, a taxpayer "must use its capital and efforts primarily in earning income from the issuance of contracts of insurance." Indus. Life Ins. Co. v. United States, 344 F. Supp. 870, 877 (D. S.C. 1972), aff'd per curiam, 481 F.2d 609 (4th Cir. 1973). All of the relevant facts will be considered, including but not limited to, the size and activities of any staff, whether the company engages in other trades or businesses, and its sources of income. See generally United States v. Home Title Ins. Co., 285 U.S. 191, 195 (1932) (where insurance and charges incident thereto were more than 75% of company's income, "[u]ndeniably insurance [was] its principal business."); Lawyers Mortgage Co. at 188-90; Indus. Life Ins. Co., at 875-77; Cardinal Life Ins. Co. v. United States, 300 F. Supp. 387, 391-92 (N.D. Tex. 1969), rev'd on other grounds, 425 F. 2d 1328 (5th Cir. 1970); Serv. Life Ins. Co. v. United States, 189 F. Supp. 282, 285-86 (D. Neb. 1960), aff'd on other grounds, 293 F.2d 72 (8th Cir. 1961); Inter-American Life Ins. Co., at 506-08 ; Nat'l. Capital Ins. Co. of the Dist. of Columbia v. Commissioner, 28 B.T.A. 1079, 1085-86 (1933). However, a company engaged solely in reinsurance may have a very sparse operation. See Alinco Life Ins. Co. v. United States, 178 Ct. Cl. 813, 837-38 (1967)(that reinsurance company had extremely simple operation with very little general operating expense did not preclude conclusion that it was a life insurance company under § 801).

In Lawyers Mortgage Co., the Court concluded the taxpayer was not an insurance company based on the character of the business actually done. The taxpayer was chartered as "Lawyers Mortgage Insurance Co." to examine titles and to guarantee or insure bonds and mortgages. Later, the company dropped "insurance" from its name and amended its charter to allow the purchase and sale of mortgage loans. It remained under the supervision of the state insurance department. However, Lawyers Mortgage never insured titles. Rather, it made mortgage loans which it sold with a guarantee of payment. For this "insurance", Lawyers Mortgage charged a "premium" of one-half of one percent of the interest stated on the mortgage. The company also guaranteed the payment of some loans which it did not make or sell. Under state law, companies chartered as banks were also authorized to conduct this type of business. The Court concluded that though the guarantees were in legal effect insurance, this element of Lawyers Mortgage's activities was only incidental to the mortgage business; the "premium" covered non-insurance services. And the "premiums" were only one-third of Lawyers Mortgage's income. The character of the business actually done was not insurance, therefore, the company was not an insurance company.

Similarly, in Industrial Life Ins. Co. the taxpayer was not an insurance company for federal income tax purposes because it was not using its capital and efforts primarily to earn income from insurance. Industrial Life was chartered as an insurance company but did not maintain a sales staff. Its office was located in the home of its president. During the three years at issue, the company's insurance activity consisted of covering small credit risks under a group policy issued to a consumer lender, covering the lives of certain of its officers (the company paid the premiums and was the beneficiary), and covering the lives of members of the stockholding family. The company also engaged in leasing and selling real estate and managing its investment portfolio. Industrial Life's premium income from insurance issued to parties unrelated to its owners/officers (i.e., the group credit risk policy) accounted for approximately 8% its income during the years at issue. The company accumulated substantial earnings without showing a reasonable need. The district court concluded that Industrial Life was not an insurance company during the years at issue. Although it was involved in direct underwriting, it issued only one policy and its premium income was small compared with its income from its real estate activity.

Cardinal Life Insurance Co. involved a company chartered to write life, health and accident coverage. During two of the five years at issue, Cardinal Life did not issue insurance contracts or reinsure risks underwritten by insurance companies; its premium income was $0 and it had no reserves. For the remaining three years, Cardinal Life reinsured risks underwritten by an insurance company; its premium income was less than 1% of its income for two of those years and approximately 9% in the third. Its reserves.were minimal. Cardinal Life never employed any agents or brokers though it did retain an actuary; the reinsurance agreement was negotiated by its one stockholder. Meanwhile, Cardinal Life had income from dividends and interest, leasing real estate and trailers, and capital gains. The district court concluded that Cardinal Life was not an insurance company because its capital and efforts were devoted primarily to its investment activity; it did not solicit insurance business and derived insignificant amounts of income from what insurance business it transacted while deriving substantial income from its investments.

Inter-American Life Ins. Co. likewise involved a taxpayer that did not qualify as an insurance company due to its minimal volume of insurance business. Two individuals formed Investment Life Insurance Company to directly underwrite coverage which could be ceded to Inter-American. Although Inter-American was authorized to use several policy forms, it did not solicit or sell any directly written coverage during the years at issue. Rather, it accepted a small amount of business ceded to it by Investment Life and an unrelated insurer. Inter-American also held the family's lumber business as loaned surplus. Because of its minimal insurance activity, the state insurance commissioner became concerned about its continued participation in the insurance market. As a result, rather than surrender its certificate of authority to write insurance, Inter-American retroceded a major portion of its coverage to an unrelated company. Meanwhile, Inter-American realized income from various capital assets. Although Inter-American had as many as 448 policies in force during the five years at issue with an aggregate coverage of $1.4 million, premiums accounted for 5% or less of Inter-American's income during four of the five years. The court concluded that Inter-American was not an insurance company for any of the years at issue because it did not use its efforts in the insurance business. It did not actively solicit to issue coverage. Its directly underwritten coverage was issued to the owner's family or their tax advisor and its reinsurance was from the related company, Investment Life. Its investment income far exceeded its de minimis earned premiums.

In contrast, the taxpayer in Service Life Ins. Co. was held to be an insurance company under different facts. During the years at issue, Service Life issued life, health and accident policies, and also solicited and arranged mortgage loans with money borrowed from the Federal Home Loan Bank. Between 35,000 and 70,000 policies were in force during the years at issue, representing life coverage of over $22,000,000. At the same time, only about 1,800 mortgages were outstanding. Service Life's premium income accounted for between 57% and 79% of its total income. Under these facts, the character of the business actually done by Service Life during the years at issue was insurance; hence it was an insurance company.

b. Analysis

No single factor determines whether a company's primary and predominant business activity for a taxable year was the issuing of insurance or annuity contracts or the reinsuring of risks underwritten by insurance companies. Thus, in some cases, a start-up company (or a company winding down operations) may qualify as an insurance company even if premiums represent less than half the receipts of the company, provided the company's capital and efforts are devoted primarily to its insurance business.

1. [redacted]

In [redacted] a commercial insurer, issued credit liability policies to [redacted] employees of [redacted] Although we received no representations to this effect, we assume [redacted] issued a sufficient number of other, unrelated contracts in [redacted] that those issued to [redacted] employees qualified as insurance contracts in their own right[7]. Risks under those contracts were reinsured with [redacted] and retroceded to [redacted]

Both risk shifting and risk distribution are prerequisite to concluding an arrangement qualifies as an insurance contract for federal income tax purposes. In particular, risk distribution incorporates the "law of large numbers" to allow the insurer to reduce the possibility that a single costly claim will exceed the amount available to the insurer for the payment of such a claim. As noted above, risk distribution also entails a pooling of premiums, so that a potential insured is not in significant part paying for its own risks. Even if the contracts issued by [redacted] qualified as insurance contracts by virtue of that company's other business, it is necessary to consider whether the risks ceded to [redacted] and retroceded to [redacted] represented a sufficient number of insureds to qualify as a block of insurance business as to [redacted] The fact that a fronting company itself qualifies as an insurance company does not eliminate the need for risk distribution as to the entity that ultimately assumes the underlying risks. Gulf Oil Corp. v. Commissioner, 914 F.2d 396, 410-11 (3rd Cir. 1990);

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7 Although not represented by the parties to the request for technical advice, A.M. Best indicates that [redacted] had more than $38 million direct written premiums, and rated the company A+.

Kidde Indus. Inc. v. United States, 40 Fed. Cl. 42, 56 (1997)(finding risk distribution where subsidiary reinsures risks of sister corporations), appeal dismissed, 194 F.3d 1330 (Fed. Cir. 1999). In the present case, the block of business assumed from [redacted] represented the credit disability risks of [redacted] individuals. These are too few "insureds" for the risks assumed by [redacted] to constitute reinsuring of risks underwritten by an insurance company. Even if the retrocession of the contracts issued to the [redacted] employees constituted reinsuring risks underwritten by an insurance company, [redacted] was an insurance company for federal income tax purposes during [redacted] only if this was its primary and predominant business activity.

[redacted] tax year lasted 21 days. During this time, it was established, capitalized, licensed, and entered into the retrocession agreement with [redacted] representing five "insured" employees of [redacted] It acquired total assets worth $5 million, including the Partnership interest in leased [redacted] of $4.5 million. Its retrocession agreement with [redacted] resulted in earned premiums of $8 and loss reserves (or, more likely, unearned premiums) of $[redacted] There is no evidence that [redacted] capital and efforts were devoted primarily to the "insurance" business. [redacted] assumed coverage depended upon the efforts of [redacted] to sell policies; [redacted] only effort was to solicit seven of its employees. [redacted] made no effort to solicit other insurance or reinsurance business. [redacted] capital was substantially disproportionate to the risks undertaken. The premium income and "loss reserves" were insignificant compared to the value of the Partnership interest.

Under the facts presented, we cannot conclude that [redacted] was an insurance company for federal income tax purposes during 1998.

2. [redacted]

During [redacted] two of the five credit disability policyholders cancelled their policies. Of the remaining three policies in force at their expiration, only one renewed. On [redacted] solicited five customers to obtain credit disability coverage through [redacted] free of premium. None accepted. No other efforts were made by [redacted] to secure additional policyholders. Thus, at the end of [redacted] only a single policyholder remained by reason of the retrocession by [redacted] to [redacted] Clearly, this did not satisfy the requirement of risk distribution; thus, the retrocession of this policy did not constitute the business of insurance as to [redacted]

Even if [redacted] retrocession of the one policy from [redacted] constituted the business of insurance, this activity was dwarfed by [redacted] investment activity. [redacted] reported premium revenue of $920, unearned premiums of $314, and no loss reserves. Its income from securities was $[redacted] and from the Partnership interest $1,634,247. [redacted] premium income was 0.05% of its total income. Inasmuch as its reported loss reserves were $[redacted] its capital was disproportionately large compared to its assumed risk. Moreover, despite the dearth of insurance activity, during [redacted]

[redacted] made no other effort to issue insurance contracts or reinsure risks underwritten by an insurance company.

For [redacted] did not qualify as an insurance company for federal income tax purposes.

3. [redacted]

For the year [redacted] only "insurance" activity consisted of the risks it assumed from [redacted] with respect to the Check Fraud Policy (and, possibly, a single credit disability policy issued in [redacted] and retroceded from [redacted] The Check Fraud Policy indemnified both [redacted] and a large number of depositors in the event of forged, stolen, or counterfeit checks. We were not provided sufficient information concerning the Check Fraud Policy to determine whether [redacted] reinsurance of that contract could involve sufficient risk shifting and risk distribution to qualify as an insurance arrangement for federal income tax purposes. For example, if the coverage was primarily of risks of [redacted][8], the arrangement would be akin to that in <u>Carnation Co. v. Commissioner</u>, 640 F.2d 1010 (9th Cir. 1981); <u>see also</u> Rev. Rul. 2002-89, 2002-2 C.B. 984, and could not by itself qualify as an insurance activity for federal income tax purposes. The fact that [redacted] paid a claim(s) totaling $[redacted] during the covered period does not alter the characterization of the arrangement. On the other hand, if the coverage extended sufficiently to risks of the depositors, the fact that [redacted] was also insured may not necessarily prevent insurance characterization. <u>See, e.g.</u>, <u>Ocean Drilling & Exploration Co. v. United States</u>, 988 F.2d 1135 (Fed Cir. 1993).

Even if [redacted] coverage of the Check Fraud Policy qualified as an insurance activity, [redacted] efforts in connection with that activity were dwarfed by its investment activities, in particular the Partnership interest. For [redacted] putative insurance premiums of $55,577 accounted for less than 4% of its total revenue of $1,727,427, and its loss reserves of $10,000[9] represented less than 1% of its total assets of. Over 95% of its revenue was derived from securities and the Partnership interest. It contracted management tasks to [redacted] but significantly those tasks did not include insurance-related tasks such as resolving claims or making commitments with respect to the "insurance" operations. The only reported board of directors meeting during [redacted] lasted four minutes; the minutes of the meeting reflect that the only discussion of prospective activities concerned the Partnership interest.

There is no evidence that [redacted] made any effort to market insurance or reinsurance other than the retrocession from [redacted] and the reinsurance from [redacted] It is clear that [redacted] did not use its capital and efforts primarily in

[redacted]

earning income from issuing insurance contracts or reinsuring risks underwritten by insurance companies.

For [redacted] did not qualify as an insurance company for federal income tax purposes[10].

If you have any additional questions, please contact John Glover at extension 2-

10 Note that on its [redacted] Form 990, [redacted] reported that it was affiliated with [redacted] The nature and extent of the affiliation is not reported; potentially, these two companies were affiliated as described by § 501(c)(15)(C) had [redacted] qualified as an insurance company for [redacted]